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No. 87-1160

In The Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, et al.
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF FOR APPELLANTS

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QUESTIONS PRESENTED

1. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation effect a taking of property in violation of the Fifth and Fourteenth Amendments by precluding the state ratemaking agency from considering constitutionally pertinent factors in determining whether to permit recovery of prudently incurred investment in cancelled electric generating units?

2. Does the Pennsylvania Supreme Court's interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation to deny utility investors any recovery of or on prudently incurred investment in cancelled electric generating units effect a taking of property in violation of the Fifth and Fourteenth Amendments where the state ratemaking agency has concluded that the appropriate balance between investor and consumer interests requires the recovery of such investment?

PARTIES BELOW

In addition to David M. Barasch, Consumer Advocate, the appellants below were Equitable Life Assurance Society, Joseph Horne Company, Kaufman's and Gimbels. The Pennsylvania Public Utility Commission was the appellee below. Appellants Duquesne Light Company and Pennsylvania Power Company were intervenors below.

STATEMENT OF CORPORATE RELATIONSHIPS

Appellant Pennsylvania Power Company is a wholly owned subsidiary of Ohio Edison Company.

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On Appeal from the Supreme Court of Pennsylvania

BRIEF FOR APPELLANTS

Duquesne Light Company ("Duquesne") and Pennsylvania Power Company ("Penn Power") appeal from the final judgment of the Supreme Court of Pennsylvania, dated October 15, 1987, holding that Act 335, as incorporated in 66 Pa.C.S. § 1315, is not unconstitutional as being violative of the Fifth and Fourteenth Amendments to the Constitution of the United States.

OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania (App. A)[1] is reported at 516 Pa. 142, 532 A.2d 325 (1987). The opinion of the Commonwealth Court of Pennsylvania (App. B) is reported at 90 Pa. Cmwlth. 98, 494 A.2d 58 (1985). The Opinion and Order of the

[1]By Order dated April 18, 1988, this Court granted Appellants' Motion to Dispense with Printing of the Joint Appendix. All references to "App." are to Appellants' Appendix to Jurisdictional Statement.

Pennsylvania Public Utility Commission ("PUC") in Duquesne's case (App. C) is reported at 51 P.U.R.4th 198 (1983). The PUC's Opinion and Order Upon Reconsideration in Duquesne's case (App. D) is reported at 52 P.U.R.4th 644 (1983). The PUC's Opinion and Order in Penn Power's case (App. E) is reported at 60 P.U.R.4th 593 (1984).

JURISDICTION

The Supreme Court of Pennsylvania entered judgment on October 15, 1987. Duquesne and Penn Power filed a timely notice of appeal in the Supreme Court of Pennsylvania on January 7, 1988, and filed a Jurisdictional Statement on January 12, 1988. This Court noted probable jurisdiction by order dated March 7, 1988. This Court has appellate jurisdiction under 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS

United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

United States Constitution, Amendment XIV, clause 3:

> [N]or shall any State deprive any person of ... property, without due process of law....

Act 335, as incorporated into § 1315 of the Pennsylvania Public Utility Code, 66 Pa.C.S. § 1315, and Chapter 13 of the Pennsylvania Public Utility Code, 66 Pa.C.S. §§ 1301-1325, are reprinted in Appendix L.[2]

[2]The Pennsylvania Supreme Court's wholly unnecessary reinterpretation of unspecified portions of the ratemaking provisions of the Pennsylvania Public Utility Code, so as to render Act 335 consistent with a general prin-

(footnote continued on next page)

STATEMENT OF THE CASE

During the late 1960s, substantial annual increases in the demand for electric power, and the massive New York City and Northeast blackouts, prompted nationwide concern that electric utilities soon would be faced with insufficient generating capacity. In Pennsylvania, the PUC opened an investigation of a perceived failure on the part of Pennsylvania's jurisdictional electric utilities to begin construction of needed plant additions. *See Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23 (1972).

This investigation led the PUC to conclude that "a desperate situation was developing" which could "within the near future . . . result in possible blackouts and customer load curtailments." *Id.* at 24. In light of this conclusion, the PUC instructed Pennsylvania's electric utilities "that immediate preparations should be made to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Id. See* App. 16h–17h. *See also, Pennsylvania Public Utility Comm'n v. Metropolitan Edison Co.*, 47 Pa. P.U.C. 56 (1973).[3]

ciple that no utility may *ever* recover its investment in cancelled facilities (App. 25a, 28a–29a) (thereby avoiding Appellants' equal protection arguments advanced below), renders the entire ratemaking chapter of the Code at issue in this case. Consequently, Appellants have printed all of Chapter 13 of the Code (relating to rates and ratemaking) in Appendix L. Throughout this Brief, Appellants refer to the statutes at issue as "Act 335 and other unspecified Pennsylvania ratemaking legislation."

[3]The following passage from the PUC's Opinion in the *Metropolitan Edison* case illustrates the pressures placed on the electric industry in the late 1960s and early 1970s to expand their generating facilities:

> This Commission, and other regulatory bodies consider essential the continuing construction of electric generating capacity to meet the energy needs of the public. Respondent and other electric companies

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In 1967, Duquesne and Penn Power, along with Ohio Edison Company, The Cleveland Electric Illuminating Company and The Toledo Edison Company, had formed the Central Area Power Coordination Group ("CAPCO"). One of CAPCO's principal objectives was to take advantage of the economies of scale through the joint construction and financing of electric generating facilities. In accordance with this objective, the CAPCO companies, in the early 1970's, authorized the construction of seven large nuclear generating units,[4] including Davis-Besse Unit Nos. 2 and 3 and Erie Unit Nos. 1 and 2, which are the four units at issue in this case (the "four CAPCO units"). Thereafter, each of the member CAPCO companies incurred substantial pre-construction expenses relating to the four CAPCO units.

In January of 1980, prior to the issuance by the Nuclear Regulatory Commission of construction permits for the four CAPCO units, CAPCO announced their cancellation. The intervening events which led to this decision are documented at length in Administrative Law Judge Joseph P. Matuschak's Report of Investigation at Dockets I-79070315 and I-79070317 (Pa. P.U.C.

(Footnote continued from previous page)

> in Pennsylvania are continuing heavy expenditures to add additional generating facilities as rapidly as possible to meet adequately the public demand for service. *To protect the public interest*, this Commission has insisted that construction be accelerated and all feasible methods adopted to meet the present emergency.

47 Pa. P.U.C. at 59. (Emphasis added).

[4]The decision to build nuclear plants was based on a 1973 study that projected 20% lower costs to CAPCO customers for a nuclear plant than for a coal plant of comparable size over the period 1981–2005. (App. 16h–17h) ("The preference of nuclear over coal in this study was on the basis of the lowest cost to the customer.")

October 15, 1982) (App. H) (the "*CAPCO Investigation*").[5] In summary, Judge Matuschak found that the 1974 recession, the mild summers and winters of 1974 and 1975, and, most importantly, the Arab oil embargo had caused wholly unexpected and unforeseeable changes in the previously consistent pattern of annual growth in electric demand confronting Duquesne and Penn Power. When combined with the accident at Three Mile Island in 1979, these circumstances demanded a re-evaluation of CAPCO's construction program. Because these extraordinary events could not have been predicted, and indeed were directly contrary to the consensus demand for expansion of generating capacity that prevailed in the late 1960s and early 1970s, Judge Matuschak concluded that CAPCO, and specifically Duquesne and Penn Power, could not be faulted for having embarked on the construction of the four CAPCO units, nor for their decision to cancel those units in 1980. To the contrary, he found that "the CAPCO decisions in regard to the Davis-Besse 2 and 3 and Erie 1 and 2 nuclear units, at every stage to their cancellation, were reasonable and prudent." (App. 19h)[6]

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[5]The *CAPCO Investigation* resulted from the PUC's decision in July of 1979 to institute proceedings against Duquesne and Penn Power for the purpose of determining whether recently announced delays in a number of CAPCO sponsored nuclear generating stations, including the four CAPCO units, were justifiable. While that investigation was pending before Judge Matuschak, cancellation of the four CAPCO Units was announced. The *CAPCO Investigation* thereafter focused upon, *inter alia*, both the prudence of CAPCO's decision to begin construction of these units and the prudence of CAPCO's later decision to cancel them.

[6]The PUC by Opinion and Order entered January 13, 1983 adopted the Report of Investigation. (App. 1i). This order was never appealed. The PUC later explicated its reasoning in its Opinion and Order Upon Reconsideration in the Duquesne case. (App. 9d). In all proceedings below, the prudent nature of the costs at issue has been undisputed.

Judge Matuschak then recommended that Duquesne and Penn Power be permitted a recovery *of* their investments in the four CAPCO units over a period of ten years but not be allowed to earn any return *on* the amount of their investment remaining to be recovered during the rest of the recovery period, thereby balancing the burden of this loss between the utilities' shareholders and ratepayers.[7] In making this recommendation, Judge Matuschak recognized that "the overwhelming weight of authority" supported the recovery through amortization *of* prudently incurred investment in cancelled electric generating projects. (App. 11h, 19h).[8] The PUC agreed and proceeded to allow Duquesne to begin recovery *of*, but not *on*, its investment in the four CAPCO units by way of a ten-year amortization in its next rate proceeding, which is the rate proceeding at issue in this case. (App. 35c–37c) The

[7]Judge Matuschak's opinion and the papers in this case contain repeated references to a "return *of*" and a "return *on*" electric plant cancellation costs. The difference between these terms is best explained by example. An investor who provides another with funds, e.g., a financial institution which lends funds to a home buyer, expects repayment in two ways. First, the investor desires ultimately to retrieve his or her initial investment, e.g., by periodic amortization or principal payments equalling the amount originally invested. In utility parlance this is referred to as a "return *of*" or "recovery *of*" the investment and usually is accomplished through "amortization" or "depreciation" charges. Second, the investor desires to receive compensation for the use of his or her funds by a periodic payment representing a percentage or other yield on the unrecovered balance of the investment, such as interest payments on a home buyer's loan. In utility parlance the compensation for use of invested funds is referred to as a "return *on*" the investment.

[8]Appellants argue, see note 21 *infra*, that as a matter of law a utility has a *per se* right to a recovery *on* as well as *of* its prudent investment made in fulfillment of its statutory duty to serve. However, in the context of the particular rate proceedings below, Duquesne and Penn Power elected to support Judge Matuschak's resolution of the issue in its entirety, rather than join those attacking his decision. Thus, each utility presented a claim for only a return *of* its investment in the four CAPCO units.

PUC later authorized Penn Power to do the same. (App. 81e–82e).[9]

The PUC's decision in Duquesne's rate case allowing a recovery *of* Duquesne's investment in the four CAPCO units was entered on January 28, 1983. However, after the record had been closed and the issues briefed, but before the PUC's decision in that case, Act No. 1982-335, P.L. 1473 ("Act 335") (App. 6m-7m) was enacted on December 30, 1982, adding Section 1315 to the Pennsylvania Public Utility Code. *See* 66 Pa.C.S. § 1315. Act 335 was adopted in response to public concern that the PUC might depart from its past practice and allow over $500 million of the costs associated with Philadelphia Electric Company's Limerick nuclear generating station then under construction to be included in rate base prior to completion. (App. 6b-7b). Act 335 effectively prohibited the PUC from doing so and, in this respect, served to confirm the PUC's past practice under which such "construction work in progress" costs ("CWIP") were, except in certain circumstances not relevant here, not permitted to be included in rate base until the underlying project or facility had been placed in service (App. 6b-7b; 10b; 12d-14d).[10]

[9]As reflected in the record, Duquesne's claim for such expenses amounted to $34,697,389, before taxes. Penn Power's claim totalled $15,609,628, before taxes. An itemization of total CAPCO expenditures on the four CAPCO units, as submitted by Penn Power to the Federal Energy Regulatory Commission ("FERC") is contained in Appendix J (App. 19j–25j).

[10]A public utility can be compensated in either of two ways for the "time value" of its funds invested in major construction projects with respect to the period between expenditure and completion of the project.

First, the carrying charges on the construction costs may be capitalized as part of the project's historical cost through an "allowance for funds used during construction," (usually abbreviated either AFUDC or AFDC) equal to "the net cost for the period of construction of borrowed

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On February 14, 1983, the Pennsylvania Office of Consumer Advocate ("Consumer Advocate") petitioned for reconsideration of the PUC's decision in Duquesne's rate case to allow recovery *of* Duquesne's investment in the four CAPCO units. The Consumer Advocate argued that Act 335 not only prohibited the inclusion of CWIP in rate base, but also prohibited any recovery *of* or *on* investment in cancelled generating units. On April 18, 1983, the PUC issued its Opinion and Order Upon Reconsideration, rejecting the Consumer Advocate's interpretation of Act 335 and affirming its prior ruling. (App. 10d-14d).

In Penn Power's case, the PUC adhered to its decision in Duquesne's case and, by Opinion and Order of April 11, 1984 (App. E), approved rate levels that included Penn Power's expense claim for a recovery, over a ten-year amortization period, *of* (but not a return *on*) its investment in the four CAPCO units.

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funds used for construction purposes and a reasonable rate on" equity used for such purposes. See FERC *Electric Plant Instruction* 3A(17). 18 C.F.R. Part 101 (1987). This approach reduces the rates of ratepayers during the precompletion period, while correspondingly increasing relative rates during the postcompletion period.

Second, the value of the construction investment may, instead, be included in rate base, in the form of CWIP, prior to the completion of construction. Under this approach no AFUDC accrues after the investment is included in rate base. As a result, this approach increases rates during the precompletion period, while correspondingly decreasing relative rates during the postcompletion period. For a further discussion of CWIP and AFUDC, *see generally*, L. SCHWARTZ, J. FLYNN & H. FIRST, FREE ENTERPRISE AND ECONOMIC ORGANIZATION: GOVERNMENT REGULATION 465-492 (6th ed. 1985).

Consequently, an anti-CWIP statute merely *defers* the timing of the receipt by a utility of a return *of* and *on* its construction investment without adversely affecting the economic value of that investment. Because cancelled plants are never completed, application of an anti-CWIP statute to cancellation costs prevents a utility from *ever* receiving a return *of* or *on* its investment in such costs.

In its Opinion and Orders of June 13, 1985, the Commonwealth Court affirmed the PUC's decisions in the Duquesne and Penn Power rate cases, holding that Act 335 was intended only to exclude CWIP from *rate base* and had no applicability to an otherwise proper *expense* reflecting the recovery *of* prudently incurred investment in cancelled electric generating units.[11] (App. 7b-8b).

In a concurring opinion, President Judge Crumlish supplemented the majority's reasoning by observing that the Consumer Advocate's reading of Act 335 would raise "serious constitutional problems" (App. 10b). As had been noted by the Commission below (App. 14d), and as had been argued by Penn Power and Duquesne, such a rule would pose a "real and not fanciful" confiscation issue.

Subsequent to the Commonwealth Court's decision, Act 1985-62, adding § 520 to the Pennsylvania Public Utility Code, 66 Pa.C.S. § 520 was signed into law on

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[11] A utility's *rate base* is that portion of a utility's investment *on* which it is entitled to receive a return. *See Louisiana Public Service Comm'n. v. FCC*, 476 U.S. 355, 365 (1986). As a utility receives a recovery *of* its investment through depreciation charges, the rate base is reduced by the amount of such charges, which are recovered over the life of a plant as operating expenses. This Court has explained:

> The total amount that a [utility] is entitled to charge for services, its "revenue requirement," is the sum of its current operating expenses, including taxes and depreciation expenses, and a return on its investment "rate base." The original cost of a given item of equipment enters the rate base when that item enters service. As it depreciates over time—as a function of wear and tear or technological obsolescence—the rate base is reduced according to a depreciation schedule that is based on an estimate of the item's expected useful life. Each year the amount that is removed from the rate base is included as an operating expenses.

Id. A statute that is intended to exclude an investment from rate base bars only a return *on* such investment, not the recovery *of* such investment.

October 10, 1985. (App. 19m-20m). The Pennsylvania legislature enacted § 520 in response to public pressure to define the PUC's authority to order the cancellation of electrical generating facilities under construction. In combination with the authority to cancel plants under construction, § 520 authorized the PUC to permit recovery *of* prudently-incurred investment in cancelled generating units by way of amortization without a return *on* the unamortized balance, precisely the result endorsed by the PUC and Commonwealth Court in this case. By its terms, however, § 520 applied only to cancellations effected after October 10, 1985.

The Pennsylvania Supreme Court reversed the Commonwealth Court in an opinion dated October 15, 1987. In that opinion, the Court recognized that the PUC had viewed "its decision to permit recovery through amortization" as

> a discharge of its duty to balance the interests of consumers and utility investors when determining what are "just and reasonable" rates.

532 A.2d at 331 (App. 11a). Nevertheless, the Court rejected the statutory construction analysis of the PUC and the Commonwealth Court, finding that the language of Act 335 was unambiguous on its face and applies to bar amortization or, for that matter, any recovery of utility cancellation costs.[12] The court then

[12]To reach this contrived result, the Pennsylvania Supreme Court disregarded the ambiguity in the language of Act 335, ignored the title and preamble to the statute, and refused to acknowledge the statute's legislative history and purpose. As the PUC and the Commonwealth Court recognized, the title and preamble to Act 335, which Pennsylvania permits to be considered in the construction of the statute, *see* 1 Pa.C.S. § 1924, makes it clear that the statute was intended only to limit consideration in *rate base* of the costs specified in the statute. (App. 5b). Moreover, the legis-

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went on to discuss the various constitutional challenges raised by Duquesne and Penn Power.

In addressing the confiscation issue under the Fifth and Fourteenth Amendments to the United States Constitution, the Court cited a multitude of this Court's decisions predating *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), but mentioned neither *Hope* nor this Court's more recent elaboration in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), nor recognized any obligation to balance investor and consumer interests in evaluating the end result of a utility rate order. 532 A.2d at 335-37 (App. 21a-26a). Instead, the Court merely held that the federal constitution's protection extends only to utility property that is "used and useful" and to operating expenses that represent "a cost of providing *present* utility service." 532 A.2d at 336 (App. 25a) (Emphasis in original).[13]

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lative history of Act 335 makes it clear that the statute was intended solely to address the issue of CWIP, and was enacted specifically to countermand the PUC's assertion in a Philadelphia Electric Company rate order that it possessed the authority to include CWIP in rate base under appropriate circumstances. (App. 7b). Although it referred to several cases in other jurisdictions that ostensibly supported its interpretation of Act 335, the Pennsylvania Court also refused even to acknowledge the decision of the Missouri Supreme Court in *State ex rel. Union Elec. Co. v. Public Service Comm'n*, 687 S.W.2d 167 (Mo. 1985). When presented with essentially the same law and facts as involved in this case, the Missouri Supreme Court in *Union Electric* recognized the serious constitutional infirmities in extending an anti-CWIP statute to cancellation costs, and, unlike the Pennsylvania Supreme Court in this case, avoided reaching the confiscation issue by adopting a limited statutory construction similar to that of the PUC and Commonwealth Court below.

[13]The Pennsylvania Supreme Court also rejected Appellants' equal protection arguments presented below, as well as Appellant Penn Power's constitutional challenge to the Court's interpretation of Act 335 to deny recovery for land held for future use. Appellants have acquiesced in these holdings for the purpose of this case and accordingly the questions presented do not encompass these issues.

SUMMARY OF ARGUMENT

1. The decision below ignored applicable constitutional standards. Under this Court's present jurisprudence, a public utility rate order is not confiscatory in the constitutional sense as long as it comports with the requirements of *Hope* and *Permian*. According to *Hope*, the "end result" of the rate order must reflect a balancing of investor and consumer interests. This Court recognized in *Permian* that the conclusory nature of the *Hope* substantive test demands that special attention be given to the procedures to be followed in assessing the balance between investor and consumer interests. Under the *Permian* procedures the ratemaking tribunal must: (1) consider all constitutionally pertinent factors and (2) articulate the reasons for the balance it strikes. The Pennsylvania Supreme Court ignored *Hope* and *Permian* and sought to invest the "used and useful" test with a contemporary constitutional dimension. The "used and useful" test, however, is a one-dimensional and result-oriented ratemaking device that cannot override the balancing of interests required by *Hope* and *Permian*.

2. The PUC's rate orders below satisfied the *Hope* and *Permian* requirements. The constitutionally pertinent factors that must be considered under *Permian* are those that inform the fairness judgment that is implicit in the concept of "just" compensation. Judge Matuschak's decision, which carefully balanced investor and consumer interests and which properly considered such factors as the fact that the investment at issue had been encouraged or required by state law, the fact that the investment at issue was undertaken to satisfy the consumer interest in uninterrupted electric service, and the fact that the investment at issue had been prudently

incurred, was incorporated by the PUC into the rate orders at issue in this case.

3. The challenged legislation is invalid, both facially and as applied, because it vests the PUC with the function of developing the constitutionally pertinent facts while simultaneously depriving the PUC of the capacity to consider all such facts. A state is essentially free to structure its ratemaking apparatus as it chooses, but the resulting process must at the very minimum permit compliance with the *Hope* and *Permian* standards. The balance between investor and consumer interests depends upon the facts of each case. The fact that an investment has been encouraged or required by state law, the fact that an investment has been undertaken to satisfy the consumer interest in uninterrupted electric service, and the fact that an investment has been incurred prudently are all pertinent to the balancing contemplated by *Hope* and *Permian*. Pennsylvania law, as construed and applied below, prohibits any consideration of these facts. The challenged legislation should be invalidated, thereby reinstating the decisions of the PUC which conformed to applicable constitutional standards.

4. Separate and apart from the PUC's rate orders having satisfied the *Hope* and *Permian* requirements, return *of* the investment in the four CAPCO units is required as a matter of law. A system of regulation (such as Pennsylvania's) that prohibits investor returns in excess of a "reasonable" return creates certain investor expectations. These have included a general expectation that at least some of the risks of loss are shared with the consumer, and a specific expectation that the investor would at least be permitted to obtain the return *of* his or her prudent investment. A rate order that

frustrates reasonable investor expectations is confiscatory. Moreover, recovery *of* their prudent investment is necessary *per se* to ensure that utility investors are "made whole." *Hope*, 320 U.S. at 606, on their investment dedicated to public use.

ARGUMENT

I. The Pennsylvania Supreme Court Ignored The Constitutional Requirement That Public Utility Rate Orders Must Reflect A Balancing Of Investor And Consumer Interests

This Court for many years has equated the "just and reasonable" standard found in most federal and state ratemaking statutes[14] with the minimum constitutional requirement for the protection of utility investors. *See FPC v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942). A rate that falls below the "just and reasonable" standard is "confiscatory in the constitutional sense." *Id.* at 585. In *Hope*, this Court established a balancing test for determining whether rates are "just and reasonable," explaining that the "fixing of 'just and reasonable' rates involves a balancing of the investor and the consumer interests." *Hope*, 320 U.S. at 603.

Hope's balancing test was a major turning point in this Court's takings jurisprudence. Prior to *Hope*, the rule of *Smyth v. Ames*, 169 U.S. 446 (1898) required courts to analyze the "fair value" of each item of utility property. By re-focusing the inquiry from the "fair value" of particular assets to a return *of* and *on* the shareholders' investment, *Hope* freed reviewing courts of the burden of having to scrutinize rate orders in

[14] *See, e.g.*, Federal Power Act, 16 U.S.C. § 824d(a), and the Natural Gas Act, 15 U.S.C. §§ 717c(a), 717d(a).

meticulous detail. The new approach established in *Hope* did not eliminate constitutional review of rate orders, but merely modified the reviewing court's role from analyzing the fair value of utility property to determining whether the "end result" of the rate order represented a balance between investor and consumer interests.[15]

In its broadest sense, the language of *Hope* may seem to suggest that ratemakers are entitled to select even arbitrary methods, as long as an appropriate end result

[15] *Hope* culminated decades of debate concerning the appropriate method by which to protect investors against confiscatory rate orders. Under *Smyth*, the "fair value" placed on the rate base had been tied to current economic conditions and price levels, rather than the original cost of the utility's investment. Beginning with Justice Brandeis' concurring opinion, joined by Justice Holmes, in *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 289-312 (1923) (Brandeis and Holmes, JJ. concurring), courts and commentators began questioning the wisdom of the "fair value" method. From a legal standpoint, the task of determining the current "fair value" of utility assets proved "laborious and baffling." *Id.* at 292. As a result, ratemakers were able to articulate a rationale to justify almost any result selected, thus effectively thwarting meaningful judicial review. *Id.* at 296-98 & n. 8. From an economic standpoint, use of the fair value method tended to produce low rates in times of deflation, when the cost of reproducing an asset was less than its historic cost, and tended to produce high rates in times of inflation, when the cost of reproducing an asset exceeded its historic cost. *Id.* at 299-304.

Justice Brandeis advocated the adoption of the "prudent investment" method as an alternative to fair value. *Id.* at 289. Under this method, utility shareholders were to be compensated not for the value of specific tangible and intangible property owned by the utility, but rather for the capital they had prudently invested. *Id.* at 290. The shareholders would be entitled to receive "the reasonable cost of conducting the business," including operating expenses and capital charges. *Id.* at 290-291.

Many of the ideas developed by Justice Brandeis in *Southwestern Bell* found their way into the opinions of this Court, in *Natural Gas Pipeline* and in *Hope*, particularly the shift in focus from assets to investment in analyzing the constitutionality of a rate order.

is somehow reached, because "[t]he fact that the method employed to reach that result may contain infirmities is not then important." *Hope*, 320 U.S. at 602. Such a broad reading of *Hope*'s end result test is, however, incompatible with the constitutional requirement for judicial review. Unless the ratemaker acknowledges its duty to balance and articulates the rationale for the balance it has struck, the reviewing court would be left with a nebulous "result" and no meaningful way of evaluating whether that result reflects a balance of investor and consumer interests.

Thus, in *Permian*, this Court recognized that the conclusory nature of the *Hope* end result test requires that the procedures followed in ratemaking cases insure that the statutorily and constitutionally-mandated balancing of all relevant factors has taken place:

> the [reviewing] court must determine whether the [rate] order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The court's responsibility is not to supplant the Commission's balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given *reasoned consideration to each of the pertinent factors.* Judicial review of the Commission's orders will therefore function accurately and efficaciously *only if the Commission indicates fully and carefully the methods by which, and the purposes for which, it has chosen to act*, as well as its assessment of the consequences of its orders for the character and future development of the industry.

Permian, 390 U.S. at 792 (emphasis added).

Permian, thus, represented an elaboration of the broad "end result" language of *Hope*. Like *Hope*, *Permian*'s standard of review does not mandate that any particular ratemaking method be selected. However, the ratemaker must inform the reviewing court of the method employed, must consider the pertinent factors, and must explain how, in the judgment of the ratemaker, application of its method to the facts of the case produces an end result that balances investor and consumer interests. The *Permian* procedures become the mechanism that permits the constitutionally required judicial review of *Hope*'s "end result."

In recent years, states have increasingly strayed from the teachings of *Hope* and *Permian*. Since the time of the Arab oil embargo, energy price inflation has produced a substantial decline in the rate of growth of consumer demand for electricity. At the same time, the cost of constructing the many large electric generating facilities, which had been planned during the decades of high growth in electricity demand, have skyrocketed. When faced with requests for rate increases to compensate utility investors for their massive investment in completed plants, and their substantial investment in plants cancelled prudently in face of declining demand, state regulators, state courts and state legislatures have experienced significant public pressure to limit the growth of electric rates.[16] As a result, many such regula-

[16]There are, of course, also important public policy considerations implicated in utility ratemaking, particularly with respect to the relationship between the treatment of the cancellation costs of unneeded plants and the treatment of completed unneeded plants:

> [A] state that prohibits recovery of all investments in canceled plants but permits a rate of return on completed plants that constitute excess capacity creates an incentive to complete a plant whether it is needed

(Footnote continued on following page)

tors, courts and legislatures have manipulated traditional ratemaking principles in an effort to minimize the resulting rates.

In this case, the Pennsylvania Supreme Court joined the growing number of courts that have completely ignored the constitutional principles of *Hope* and *Permian*.[17] Although it adverted to the PUC's balancing effort below, the Pennsylvania Court, through its interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation, obliterated the balance struck by the PUC. In doing so, the Court made no effort to determine whether under its construction of the applicable state law "each of the pertinent factors" identified

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or not. A state that disallows investments in excess capacity but permits recovery of investments in canceled plants creates an incentive to cancel a plant if there is any likelihood that its completion will result in excess capacity. A state that precludes recovery of investments in canceled plants and disallows investment in excess capacity creates a third type of incentive: to refrain from constructing a new plant until there is absolute certainty that a new plant is needed.

Pierce, *The Regulatory Treatment of Mistakes in Retrospect: Canceled Plants and Excess Capacity*, 132 U. Pa. L. Rev. 497, 524 (1984) (footnotes omitted). But the fairness considerations implicit in the Takings Clause impose constitutional limits on the ability of states freely to employ these regulatory tools.

[17] *See e.g., Dayton Power & Light Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d. 91, 447 N.E. 2d 733 (1983) ("The federal constitution no longer provides any special protections for utility investors.") The Pennsylvania Consumer Advocate in this case has even argued that *Hope* is merely a doctrine of judicial restraint that eliminates review of state rate orders under the Fifth and Fourteenth Amendments unless the impact of such an order is to bring the regulated utility to the brink of bankruptcy. *See* Motion of Appellee, David M. Barasch, Consumer Advocate, to Dismiss or Affirm, pp. 26-41. There is no reason why in the public utility field—as opposed to any other area of state economic regulation—a litigant should be required to demonstrate virtual economic destruction as a prerequisite to standing to advance federal constitutional claims. Certainly, *Permian* does not stand for that proposition.

in *Permian* could be considered. Instead, the Court leaped backwards over *Hope* and *Permian* to resurrect isolated statements from *Smyth* and its progeny. The Court sought to justify the constitutionality of its statutory interpretation by holding that only "used and useful" property is entitled to constitutional protection.

The "used and useful" test is inconsistent with the balancing of interests required by *Hope* and *Permian*. Like the statutes at issue in this case, the "used and useful" test is a loaded standard that focuses retrospectively only on the consumer interest in receiving service at the lowest possible rate and not the range of other investor and consumer interests in the investment at issue. The "used and useful" test is therefore a one-dimensional and result-oriented ratemaking device that cannot override the balancing requirement of *Hope* and procedural safeguards required under *Permian*. *See Washington Gas Light Co. v. Baker*, 188 F.2d 11, 18-19 (D.C. Cir. 1950) (Bazelon, J.).

The Pennsylvania Supreme Court thus retrieved a ratemaking methodology from this Court's pre-*Hope* jurisprudence and gave that methodology a contemporary constitutional dimension. This decision results in a rate order that is unfair to utility investors, who invested their own funds in the design and engineering of four electrical generating units for the public benefit, and recovered *nothing* as compensation for this investment. Reversing the anachronistic approach taken by the Pennsylvania Supreme Court would serve to instruct state ratemakers, legislators and courts to be faithful to the balancing of interests mandated by *Hope* and *Permian*.

II. The PUC Orders Below Reflect A Balancing Of Investor and Consumer Interests.

In this case, the PUC adhered to its obligations under *Hope* and *Permian*. In each of the rate orders under review, the PUC adopted the reasoning and the end result recommended by Judge Matuschak in the *CAPCO Investigation*. Judge Matuschak had carefully balanced investor and consumer interests as contemplated by *Hope*, and had articulated his reasoning as required by *Permian*. This careful balance was destroyed by the Pennsylvania Supreme Court's unconstitutional interpretation of Act 335 and other unspecified Pennsylvania ratemaking legislation.

Just compensation is a principle of fairness.[18] The compensation of individuals for their investment that has been dedicated to public use involves a judgment as to what is fair under the circumstances of each particular case. Thus, in evaluating which factors are "pertinent" to the constitutionally mandated balancing of investor and consumer interests, ratemakers should be guided by "considerations of justness and fairness." *Natural Gas Pipeline*, 315 U.S. at 607 (Black, J. concurring).

Judge Matuschak was guided by these considerations. Before recommending that the Duquesne and Penn Power shareholders receive a return *of* their investment in the four CAPCO units, he surveyed the treatment of cancellation costs in other jurisdictions. This survey provided Judge Matuschak with a means

[18] *See generally*, Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967).

of articulating many of the investor and consumer interests pertinent to the balancing process required by *Hope* and *Permian* that he considered in reaching his decision.

For example, Judge Matuschak quoted from a decision of the Public Utility Commission of Texas, which recognized that permitting shareholders to recover their investment in cancelled plants "provides a necessary incentive for the utility to take reasonable investment risks for the benefit of ratepayers." (App. 11h). Judge Matuschak had before him the fact that the four plants at issue were planned and started at a time when electricity demand was rising steadily (App. 16h) and that the PUC itself had insisted upon the Pennsylvania utilities increasing their construction of new generating plants. Indeed, the investments at issue discharged the utilities' statutory duty to provide electric service to consumers. *See* 66 Pa.C.S. § 1501. Thus, the *consumer* interest in uninterrupted electric service was a pertinent factor that supported, if not mandated, incurring the costs at issue. It is only fair that if electric utilities are required by law and public policy to invest in generating capacity in the public interest, they should at least recover the cost of their investment.

Moreover, the changes in circumstances which forced the cancellation of the four CAPCO units were not reasonably foreseeable. Thus, another pertinent factor was the unfairness of requiring a utility to undertake an investment in the public interest and then retrospectively denying a recovery of that investment when unforeseeable circumstances cause it to be cancelled. Judge Matuschak recognized this fairness principle in quoting from a FERC decision involving the St. Rosalie plants.

(App. 12h). In that decision, FERC had rejected the notion that the cancelled plants necessarily represented a "mistake." Rather, FERC had found that the cancellations "simply resulted from a change of circumstances which could not reasonably have been foreseen." *Id.*

Judge Matuschak also considered the fact that the decision to invest in the preconstruction costs of the four CAPCO units, and each subsequent decision up to and including the decision to cancel the units, were reasonable and prudent. Simple fairness dictates that shareholders who have invested in the public interest should not be penalized when their investments have been found to be reasonable and prudent. Judge Matuschak quoted with approval from decisions of the Michigan, California and Maine commissions (App. 12h–14h), in which the commissions considered the reasonableness and prudence of the investment "[i]n an attempt to balance equitably the responsibility as between investors and consumers in connection with cancellation costs of abandoned plants. . . ." (App. 13h). He thus concluded that "the overwhelming weight of authority" supported "the principle that an expense prudently incurred, even for a project later cancelled or abandoned because of changed circumstances, is a proper expense for ratemaking purposes." (App. 11h).

The final factor that Judge Matuschak considered was the consumer's interest in not having to pay unreasonably for an investment that does not provide them with present electric service. Although he did not articulate this consumer interest as such, he accounted for it by way of his holding that Penn Power and Duquesne shareholders be denied a return *on* their investment.

All of these constitutionally pertinent factors were developed in the record before Judge Matuschak. Unburdened by Act 335, which had not been adopted, Judge Matuschak considered these factors and struck a balance. He permitted the shareholders to recover the amounts they had invested, without recovering interest or any other return *on* their investment during the recovery period. Under this approach the shareholders do not profit from their investment, but also are not forced to bear the risk of the entire loss. Judge Matuschak's recommendation, which was adopted by the PUC, thus represents "a proper balancing between investor and consumer interests." (App. 19h).

III. The Challenged Legislation Unconstitutionally Precludes the PUC From Considering Factors Pertinent To The Balance Between Investor and Consumer Interests

Historically, state ratemaking commissions were formed to relieve legislatures of the cumbersome task of setting rates by legislation. In delegating legislative tasks to a ratemaking agency, the legislature provides minimum standards to define the agency's duties and powers. On the other hand, where the ratemaking decisions of the agency can have constitutional implications for private parties, the agency must be invested with discretion sufficient to conform its decisions to constitutional mandates. The lesson of *Hope* and *Permian* is that rate orders must reflect a balance of investor and consumer interests in order to avoid a taking of property without just compensation. Consequently, a necessary corollary of the *Hope* balancing test is that a state ratemaking agency must possess under state law sufficient discretion within the boundaries of its ratemaking

authority to balance investor and consumer interests and thereby produce a constitutional end result. In short, *Hope* and *Permian* require that the one who sets rates must balance.[19]

In Pennsylvania, the one who sets rates, the PUC, is statutorily precluded, for the purpose of this case,[20] from balancing investor and consumer interests when considering a utility's investment in cancelled electric generating units. *Permian* requires that the ratemaking agency articulate "fully and carefully the methods by which, and the purposes for which, it has chosen to act," and assess the consequences of its action on the balance between investor and consumer interests. 390 U.S. at 792. As interpreted by the Pennsylvania Supreme Court, Act 335 and other unspecified Pennsylvania ratemaking legislation now permit consideration

[19]In concept, this principle is not unlike the familiar administrative law principle developed from notions of due process that "the one who decides must hear." *See Morgan v. United States*, 298 U.S. 468, 481 (1936).

[20]Because the cancellation date of the four CAPCO units fell within the bizarre gap between Act 335 and the subsequently enacted § 520, 66 Pa.C.S. § 520, the costs at issue in this case are the only investments in cancelled electric generating units that are barred by the Pennsylvania Supreme Court's interpretation of Act 335. Section 520 permits amortized recovery *of* (but not a return *on*) the prudently incurred costs of cancelled electric generating units. But § 520 applies by its terms only to cancellations effected after October 10, 1985, a date conveniently subsequent to the well-known January 22, 1980 cancellation date of the four CAPCO units. The arbitrary and irrational interplay between Act 335 and § 520, as well as the Pennsylvania Supreme Court's arbitrary and result-oriented "heads the consumer wins, tails the utilities lose" interpretive approach do not even satisfy the existing due process standards for testing state economic regulation under the Fourteenth Amendment. *See generally Nebbia v. New York*, 291 U.S. 502, 525 (1934) and its progeny (requiring that economic regulation not be arbitrary and irrational). *See also Permian*, 390 U.S. at 769–70. In addition, by enacting § 520, the Pennsylvania legislature has itself conceded that denial of the recovery *of* prudently incurred investment in cancelled electric generating units is not necessary to protect any constitutionally pertinent consumer interest.

of only *one* factor in determining whether to compensate Duquesne and Penn Power shareholders for their investment in the four CAPCO units: whether the units are providing present electric service to Duquesne and Penn Power consumers. This legislation, therefore, prevents the PUC from considering any other constitutionally pertinent factor, such as the fact that the investment by the Duquesne and Penn Power shareholders was undertaken to protect the consumer interest in receiving uninterrupted electric service, the fact that their investment was encouraged or required by state law, or the fact that their investment, though not resulting in a completed facility, was prudently made. In short, the Pennsylvania legislature has attempted through Act 335 and other unspecified ratemaking legislation to place its heavy finger selectively on the balance between investor and consumer interests without itself undertaking the full analysis of pertinent factors required by *Hope* and *Permian*.

The challenged legislation is facially invalid because it vests the PUC with the function of developing the constitutionally pertinent facts while simultaneously depriving the PUC of the capacity to consider such facts. Under these constraints, the PUC is incapable of framing a rate order that satisfies the *Hope* and *Permian* requirements. Moreover, the challenged legislation is invalid as applied, because, as Judge Matuschak recognized, the facts of this case establish strong investor and *consumer* interests that supported recovery *of* the shareholder's investment. Where the PUC is precluded from considering these interests, it is constrained to produce a rate order that does not reflect a balance of investor and consumer interests with respect to the

Duquesne and Penn Power investment in the four CAPCO units.

The challenged legislation should be invalidated, thereby reinstating the decisions of the PUC which conform to applicable constitutional standards.

IV. Return Of The Investment In The Four CAPCO Units Is Mandated As A Matter Of Law

Separate and apart from the PUC's rate orders having satisfied the *Hope* and *Permian* requirements, the challenged legislation should also be invalidated because it both frustrates the reasonable expectations of utility investors and prevents them from being compensated for their prudent investment dedicated to public use. The reasonable expectations of utility investors requires recovery, *per se*, *of* a utility's prudent investment in cancelled electric generating units. Recovery *of* their prudent investment is also necessary to ensure that utility investors are made whole on their investment dedicated to public use in satisfaction of the utility's duty to serve.

The unfairness of saddling a utility investor with risks he or she could not have expected underlies this Court's analysis in both *Hope* and *Permian*. This Court recognized that the extent to which a rate order will "fairly compensate investors for the risks they have assumed" is a pertinent factor to be considered in the balancing of investor and consumer interests. *Permian*, 390 U.S. at 792.[21] This Court has also considered

[21] The "balance" struck by Judge Mutuschak and the PUC below would not produce a complete economic retrieval of the utility shareholders' investment, because the denial of a return *on* the unamortized balances during the ten-year amortization period would take from the investors the

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whether governmental conduct interferes with "reasonable, investment-backed expectations" in determining whether a taking has occurred. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979).

Investor expectations concerning risk and reward must be viewed prospectively from the time of the investment, and in the context of the existing regulatory environment. A system of regulation that prohibits investor returns in excess of a "reasonable" return on the utility's investment creates an expectation that at least some of the risks of loss are shared with the consumer. The investors give up the opportunity to reap higher returns on their prudent investment and the freedom to pick and choose whom they serve in exchange for rates permitting a recovery of their prudent investment and a reasonable return thereon. One commentator has explained:

> In the early 1970's, when utilities first committed billions of dollars to the generating plants that are being completed (or cancelled) in the 1980's, they

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time value of their invested funds. The effect of this balance is to require the utility investors to provide consumers with what amounts to an interest-free loan. The economic consequence of lengthening the amortization period can be dramatic. During the *CAPCO Investigation*, Judge Matuschak recognized that Duquesne:

> has paid its costs in connection with the cancelled plants for the past eight years, and will continue to do so over the next ten years. The investors will pick up more than 50% of the associated costs even if the Company's claim [for recovery *of* such costs] is paid in full.

(App. 19h–20h). In light of this effect of the amortization period on the recovery *of* a utility shareholder's investment, it can be argued that utilities are constitutionally required to receive a return *on* the unamortized balance during the amortization period in order to enable them to receive a full recovery *of* their investment. This issue, however, is not presented in this appeal. Both Duquesne and Penn Power acquiesced in Judge Matuschak's balancing of interests in the *CAPCO Investigation* and neither utility presented a claim for a return *on* the unamortized balances in the rate proceedings at issue in this case. *See* note 8 *supra*.

> premised their investment decisions on a form of social contract with regulatory agencies. In that era, the rough contours of the social contract seemed reasonably well-settled and supported by a broad political consensus. The utility agreed to make a substantial investment and to forgo the opportunity to earn a supernormal return if the investment proved to be unusually good. In return, the utility expected the opportunity *to recover the full cost of its investment* and to earn a "normal" return even if the investment proved to be unusually bad. This expectation was subject only to the remote risk that regulators might find that the utility acted imprudently in making the investment.

Pierce, *A Proposal to Deregulate the Market for Bulk Power*, 71 VA. L. REV. 1183, 1200 (1986) (emphasis added). This sharing of risks has also been described as "a compact of sorts," *Jersey Central Power & Light Co. v. FERC*, 810 F.2d 1168, 1189 (D.C. Cir. 1987) (Starr, J., concurring), and "the substitute for the state in the performance of the public service." *Southwestern Bell*, 262 U.S. at 291 (Brandeis and Holmes, JJ., concurring).

Recovery *of* their investment thus is necessary, at minimum, "to compensate investors for the risks they have assumed."[22] *Permian, 390 U.S. at 792.* Where a regulatory system consistently permits recovery *of* a utility's prudent expenses, shareholders invest with the expectation that they will receive such a recovery. The rate of return they receive reflects the corresponding

[22] In his dissent in *Jersey Central Power v. FPC*, Judge Mikva explained how consideration of investor risks results in a rate order that strikes the same balance as the PUC struck below:

> In an unregulated environment, the customer would not be deemed a risk-taker. He invests no capital in the enterprise and therefore bears neither the upside nor the downside risk. The investors are the

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level of risk. *See Washington Gas Light*, 188 F.2d at 19. Where a state changes the governing rules *after* the investment is made so as to deny any recovery *of* prudent expenses, the investor is deprived of compensation, because he had not been receiving a return *on* his investment corresponding to the risk of nonrecovery and he is now deprived of his expected recovery *of* the out-of-pocket funds he has invested. *Cf. West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 67-71 (1935). When such compensation is denied, the resulting rates become unconstitutionally confiscatory.

A rate order is also confiscatory if it denies utility investors a recovery *of* their prudent investment made pursuant to the utility's statutory duty to serve. In his historic concurrence in *Southwestern Bell*, Justice Brandeis recognized that a utility investor has a constitutionally protected interest in his investment because that investment has been devoted to the public service.

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> risk-takers. Under price regulations, which affords the utility a "natural monopoly" on service, some of the risk at either end of the spectrum is shifted onto the ratepayer. The transfer, however, is not so dramatic as to relieve the stockholder of the entire risk of loss.
>
> Application of this principle is readily apparent in the Commission's current treatment of electric utility plants, investments prudent when made but sometimes frustrated in fruition. If the investment is successful, the customer benefits from controlled rates for the service provided. But the ratepayer also shares the costs if the investment fails; he must pay for the expenditure made on an unproductive facility from which he obtains no service. From the investor's viewpoint, price regulation cabins both his upside and downside risk. He cannot collect the windfall benefits if the project is a boon; he does not bear all costs if the project is a bust. Electric utility stockholders do not lose equity in the non-serviceable facility, as they might in the marketplace. They simply do not procure a return on the investment.

810 F.2d 1168 (D.C. Cir. 1987), at 1121-22 (Mikva, J., dissenting). Despite their widely divergent positions regarding whether the utility was entitled to a return *on* its amortized cancellation costs, none of the opinions in *Jersey Central* ever suggested that the utility was not entitled to a return *of* such costs.

262 U.S. at 292. An electric utility is unlike most other regulated or unregulated enterprises because it is required by law to provide continuous electric service to its customers regardless of the risks, while at the same time the rewards it is entitled to receive are tightly controlled by the PUC. Under these circumstances, fairness requires that where investors have made an investment for the benefit of the consumers and in furtherance of the utility's statutory obligation to serve, and their investment has been found to be reasonable and prudent, the shareholders must, at least, receive a recovery *of* their investment.

The Court's language in *Natural Gas Pipeline* suggests that capital investment loss is fully recoverable by amortization:

> Capital investment loss at the end of the life of a business can only be avoided by restoration of the investment from earnings, and is avoidable so far as is humanly possible only by an appropriate charge of amortization to earnings as they accrue.

315 U.S. at 594. *Hope's* treatment of depreciation costs, moreover, supports recovery *of* a utility's prudent investment.[23] In *Hope*, the utility challenged the basing of

[23]The balancing test of *Hope* focuses on claims of confiscation where a utility has received a smaller return *on* its investment than it had expected. *See e.g., Hope*, 320 U.S. at 603 ("the return to the equity owner should be commensurate with returns *on* investments in other enterprises having corresponding risks") (emphasis added). Moreover, the long controversy surrounding the proper ratemaking treatment of utility assets and investment focused on the return *on* the assets or investment of the utility. This controversy should not obscure the established consensus that the utility investor is entitled to, and therefore expects to, recover from the consumer all proper expenses, including a return *of* his investment through amortization or other charges to the operating expense account. In the pre-*Hope* era this Court permitted recovery of all "reasonable" expenses. *See, e.g., Lindheimer v. Illinois Bell Telephone Co.*, 292 U.S. 151 (1934); *Dayton Power &*

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annual depreciation charges on original cost. *Hope*, 320 U.S. at 606. In approving the Federal Power Commission's treatment of depreciation, this Court in *Hope* justified the new method because "by such a procedure the utility is made whole and the integrity of its investment maintained." *Id.*[24] *Hope* thus distinguished between a utility's return *of* its investment, for which it must be "made whole," and a utility's return *on* its investment, which must reflect a "balancing of the investor and the consumer interests." *Id.* at 603. This distinction suggests that utilities are entitled to more than simply a balancing of interests with respect to recovery *of* their prudent investment—they are entitled *per se* to such a recovery.[25]

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Light Co. v. Public Utilities Comm'n, 292 U.S. 290 (1934). Following *Hope*, as set forth in the text, this practice continued by way of permitting recovery of all "prudent" expenses.

The Pennsylvania Supreme Court (App. 24a) construed *Lindheimer* and *Dayton* as establishing a *per se* rule that expenses, such as those for engineering, forward planning and procurement, which do not provide "*present* utility service" are in effect not "reasonable" and hence are not recoverable. Neither case supports this result-oriented and illogical conclusion. The Pennsylvania Court, of course, could not and did not overturn the record finding of reasonableness and prudence. (App. 19b). Once one understands the distinction between the rate base and the operating expense account, *see* note 11, *supra*, there is no logical reason why disallowance of an item from rate base because it does not provide present utility service necessarily requires disallowance of the item from the operating expense account as well.

[24]This Court referred generally to the dissent of Justice Brandeis in *United Railways & Electric Co. v. West*, 280 U.S. 234, 259–288 (1930). 320 U.S. at 606 & n. 11. In *West*, Justice Brandeis, with Justices Holmes and Stone concurring, had objected to tying depreciation recovery to the fair value of particular assets, rather than treating depreciation as a return *of* the capital invested by the utility shareholders.

[25]Where a utility is denied a return *of* its investment, investors are forced to forfeit funds that they have invested from their own pockets. The distinction in *Hope* between return *of* and return *on* the utility shareholder's investment is analogous to the land-use area where physical invasion of property is treated under a higher standard than regulations that

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Since *Hope*, federal courts have recognized that utilities are entitled to recover amounts invested in prudently incurred expenses, including engineering expenses similar to those involved in this case. *See Mississippi River Fuel Corp. v. FPC*, 163 F.2d 433, 438 (D.C. Cir. 1947) (referring to engineering costs). The court in *Mississippi River Fuel* recognized that it was confiscatory for a ratemaking agency to deny recovery *of* prudently incurred expenses.[26]

Hope and *Permian* are grounded in the theories of utility ratemaking contained in J. BONBRIGHT, VALUATION OF PROPERTY (1937). Bonbright was at the forefront of developing the notion that a ratemaking agency need not employ any particular methodology, as long as the method employed is applied consistently. Bonbright was also aware that principles of "fair play" require that when changes are made to ratemaking

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merely diminish the expected value of an individual's property. *See, e.g., Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 435-38 (1982); *United States v. Causby*, 328 U.S. 256 (1946). *See generally, Keystone Bituminous Coal Assoc. v. DeBenedictis*, 107 S.Ct. 1232, 1244, n. 18 (1987). Denial of a recovery of a shareholder's investment, like a physical invasion, takes from a person something that was once physically in his possession, and thus rises to something more than merely "adjusting the benefits and burdens of economic life to promote the common good." *Penn Central Transportation Co. v. New York City*, 438 U.S. 104, 124 (1978). In contrast, denial of a return *on* investment, like a regulatory land-use taking, interferes with the expected value of an individual's property. Recovery *of* prudently incurred costs is thus deserving of protection *per se*.

[26] As the District of Columbia Circuit recognized in *Mississippi River Fuel*:

> Expenses (using that term in its broad sense to include not only operating expenses but depreciation and taxes) are facts. They are to be ascertained, not created, by the regulatory authorities. If properly incurred, they must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce.

163 F. 2d at 437.

methodologies the costs borne and rewards received by investors and consumers be related to their expectations and the risks they have assumed. *See* 2 J. BONBRIGHT, VALUATION OF PROPERTY at 1155 & n.113 (1937).

The Pennsylvania Supreme Court's decision in this case does violence to the reasonable expectations of utility investors by applying a statutory standard that was not in existence and could not have been anticipated when they made their prudent investment in the four CAPCO units. This decision saddles the investors of Duquesne and Penn Power with risks that they did not voluntarily assume, and denies them *any* compensation for their prudent investment in the design and engineering of four electrical generating units that were undertaken pursuant to a public duty. Denial of any recovery *of* the costs prudently invested in the four CAPCO units effects an unconstitutional taking of the investors' property.

CONCLUSION

This Court should reverse the judgment below, thereby reinstating the decisions of the PUC which conformed to applicable constitutional standards.

Respectfully submitted,

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